

# Informal Trade in Sri Lanka\*

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## **Executive Summary**

Informal sector has been variously described in the literature. In spite of these descriptions, the definition of informal economy remains controversial. Informal trade, which seems to be the main component of informal sector, is widely seen in most countries in the world including in Sri Lanka. It seemingly comprises various activities including micro and small scale trading enterprises, petty trade, and other small commercial activities. Informal trade can be seen in both rural and urban areas in Sri Lanka. The nature, extent, characteristics, and the anatomy of the informal trade sector in Sri Lanka are hardly known at present.

The objectives of this paper are: to identify the extent of informal trading activities in Sri Lanka; to recognize the fundamental reasons for the existence of informal trade; to identify the basic elements of a plan of action for developing the informal trading sector, especially through connecting informal activities with formal activities; and to explain as to how development of informal trade sector helps eradicate poverty. Existing data from various sources is used in the analysis.

Section two describes existing literature on informal domestic and foreign trade in Sri Lanka. There are some studies explaining the activities of informal foreign trading activities in Sri Lanka, though they are highly inconclusive. However, there are no comprehensive studies explaining the nature, extent, characteristics, and the anatomy of informal domestic trading sector in Sri Lanka.

The extent of informal trade sector is documented in the section three using existing data. It is noted that informal foreign trading activities in Sri Lanka is considerably large. Though there are no reliable data to quantify the informal trading activities of the domestic sector, the sector is considerably large according to available information. Most of the small and micro scale business enterprises in the country belong to the informal category.

An attempt is made to explain the fundamental reasons for the existence of informal trading sector in Sri Lanka. Various factors are identified as responsible for persistence of informal trading sector in Sri Lanka. First, the transactions costs are lower in informal sector compared to those of formal sector. Second, the presence of high tariffs and non-tariff barriers and a rigorous import licensing scheme provide incentives for some to engage in informal foreign trade. Third, due to deficiencies in government procurement mechanisms, micro and small scale traders prefer to operate informally. Fourth, informal traders are less prone to corruption and red tape. Fifth, informal traders have the ability to realize payments quicker compared to formal channels. Sixth, informal sector exhibits smaller and manageable size of operation. Seventh, there are relatively competitive marketing conditions in informal trade sector. Eighth, compared to formal sector, there is relative easiness of entry into business in informal sector. Finally, since there are procedural delays and higher paper work in the formal operations, small and micro scale businesses prefer to operate informal.

We also attempt to document some of the important implications of the informal sector trading activities in Sri Lanka. First, it was identified that the quality of the product traded is low and trading environment is very weak. Second, informal traders do not have proper access to formal

financial facilities due to many reasons. Third, there is no appropriate and developed dispute settlement mechanism affordable for the informal traders. Fourth, informal traders lack accurate information at lower costs. Fifth, there is no formal social security scheme for the workers in the informal trading sector especially to assist them in the old age. Sixth, it is also noted that the existence of informal sector leads to misguided policy responses by the government. Seventh, persistence of informal traders leads to erosion of competitiveness. Eighth, informal traders lack the access to public goods and services due to illegal operations. Ninth, there is lack of security for prosperities of informal trade sector. Finally, it is also argued that both perpetual existence of informality as of the present state as well as formalization in the conventional manner imposing additional costs to the traders lead to persistent poverty.

Sixth section of the paper provides some of the guidelines for developing the informal trading sector in Sri Lanka. First, it emphasizes that the necessary conditions should be created for reorganizing of informal traders. Second, the employment contracts of the sector need to be formalized. Third, commercial relationships should be formalized. Fourth, these traders require formal property titles to empower them to increase the access to resources and legal system. Fifth, there needs to be a formal social security scheme for the workers in the informal trading sector. Sixth, the marketing conditions of various informal sales points should be developed, especially in *Sathipola*. Seventh, the basic facilities necessary for the *Sathipola* and itinerant traders should be provided as part of the formalizing package. Eighth, measures should be taken to remove the entry barriers available in informal trading sector, in which legal system should be developed in line with the “ability to comply”. Ninth, pro-poor business rules and regulations must be

developed and implemented. Finally, training facilities need to be provided to informal sector traders.

Final section summarizes the paper emphasizing that there is very little knowledge about informal trading sector in Sri Lanka. We also emphasize that there should be a country-wide survey to ascertain the nature, extent, characteristics, and the anatomy of the informal trading sector before making and implementing policies to develop the sector.

## **1. Introduction**

Informal sector has been diversely described in the literature – the ‘unorganized sector’, ‘unregistered economy’, ‘black economy’, and ‘shadow economy’ (Sandaratne 2004). Notwithstanding these descriptions, the definition of the informal economy has remained controversial. Informal trade, which seems to be the main component of informal sector, is widely seen in most countries in the world. It seemingly comprises various activities including small and medium scale trading enterprises, petty trade, and other small commercial activities. Informal trade can be seen in both rural and urban areas in Sri Lanka.

Informal trading activities are normally placed outside of the purview of government regulations or policies (at least to a great extent), taxations (there are various taxes) and various charges, and business permit charges. They include both illegal activities as well as legal activities. Some informal activities may be included in national income data and may come under some government taxes, but others which belong to the unorganized sector are not included in the national accounts. The definition that is used here is basically based on “status of employment”. It includes four categories: legal status, accountancy (excluding incorporated and quasi-incorporated firms), employment size of the enterprise (normally less than five workers per enterprise), and registration. Within the informal sector so defined, the criterion of status in employment allows to distinguish two sub-categories: own-account enterprises which do not employ permanent employees but may employ casual or family workers, and informal employers’ enterprises which do employ permanent employees with respect to the already mentioned criteria.

It is important to explain the possible impact of informal sector or reforming it on poverty. One of the fundamental arguments of this paper is that development of informal sector in Sri Lanka basically helps eradicate poverty. A majority of employees in the informal trading sector comes from the lower income groups of the society. A larger share of informal trading enterprises is also owned by poor individuals. There are informal enterprises owned and managed by well-off individuals. Nonetheless, most of the employees in these enterprises are from the poorest segment of the society. Hence, any measure taken to develop informal trade sector directly affects the poor. We examine informal trading sector in Sri Lanka along with these observations.

The objectives of this paper are:

- To identify the extent of informal trading activities in Sri Lanka,
- To recognize fundamental reasons for the existence of informal trade,
- To identify basic elements of a plan of action for developing the informal trading sector, especially through connecting informal activities with formal activities, and
- To explain as to how development of informal trade sector helps eradicate poverty.

Given the limitations of data on informal economic activities in general and informal trading activities in particular, a comprehensive and a thorough analysis of it with reference to Sri Lanka involve a data generating process. Such an exercise is both time consuming and costly. However, this paper attempts to draw information from various secondary sources together with information from field observations and discussions undertaken with informal traders in

*Sathipola* (weekly trade fair) of *Pilimatalawa*, *Kadugannawa*, and *Gampola* in *Mahanuwara* district. Discussions were also held with some pavement vendors and itinerant sellers. Collection of information in this way was done in an informal manner.

## **2. A Brief Review of Existing Studies with Reference to Sri Lanka**

There is a dearth of literature on informal sector activities in Sri Lanka providing a fundamental understanding of the sector though there are some general and ill-treated exercises. Some existing studies basically focus on the overall picture of informal sector. Marga Institute (1979) has conducted a survey of informal sector in the Colombo city. This work made a significant contribution to understanding of informal activities and a conceptualization of informal enterprise of the urban areas in Sri Lanka. It identified the magnitude and characteristics of informal sector in the Colombo city. Marga Institute (1992) subsequently undertook a follow up study based on a survey in the Colombo city which is still unpublished. However, given the vast amount of studies undertaken in various disciplines with regard to formal economic activities which comprise only less than 50% of the total economic activities, almost half of the economic activities in the country seem to have been largely unexplained in Sri Lanka.

Sanderatne (1989, 1991, 2004) in a series of papers has contributed to understanding of informal sector in Sri Lanka. In an article titled “the Informal Sector in Sri Lanka: Dynamism and Resilience” appeared in Chickering and Saldine’s, *Silent Revolution*, gives a description of diverse activities of informal sector with profiles of informal enterprises in Sri Lanka. It also discusses the difficulties faced by informal enterprises. Sanderatne’s paper “The Informal Economy: Issues and Perspectives” appeared in *Upanathi* (1989) is a more formal analysis of the

informal sector. It focuses on urban informal sector. It also provides a graphic overview of the sub-sectors of urban, rural and estate informal activities. In another paper, Sanderatne (2004) examines the impact of globalization on informal sector concluding that globalization has positively contributed to expanding informal sector. These papers focus on the overall anatomy and characteristics of the informal sector in Sri Lanka. They do not include adequate micro-level data. Moreover, these papers do not specifically analyze informal trade sector in Sri Lanka.

Some discuss informal foreign trade in the South Asian region. Sri Lanka's informal trade with a few of the neighboring countries was highlighted in a number of studies recently. Taneja et al (2002) in an article titled "Informal Trade in the SAARC region: a case study of India, Sri Lanka, Nepal" estimate the size, characteristics, and reasons for informal foreign trade between the South Asian countries. It basically pins the blame on various trade barriers for the presence of informal foreign trade. Ghafur (1990) has highlighted illegal international trade in Bangladesh with a few neighboring countries. Karmacharya (2002) has also analyzed informal trade in the SAARC region assessing the size and the reasons for informal trade. Sarvananthan (1994), in a series of papers, has analyzed contraband trade and unofficial capital transfers between Sri Lanka and India. However, current understanding on informal foreign trade in Sri Lanka is very blurred. Further insights can only be drawn through carefully executed surveys to measure the extent and characteristics of informal foreign trade in Sri Lanka. Proper measurement techniques must also be developed since there are no generally accepted techniques to measure the extent of informal foreign trade.

There is lack of studies on domestic informal trade sector in Sri Lanka. One of Sandaratne's (2004) papers which analyses the impact of globalization on informal sector tries to exhibit the importance of informal commerce in Sri Lanka. It basically explains that globalization has positively contributed to developing the informal sector in Sri Lanka, especially informal trade. However, the nature, extent and characteristics of informal trade in Sri Lanka are not yet clearly known. As a result, further studies are highly warranted before formulating and implementing any effective policies for developing the informal trade sector in Sri Lanka.

### **3. The Extent of Informal Trade**

The existing information suggests that the informal sector in Sri Lanka accounts for about 47 percent of the total economic activities of the country in 2003 (Schneider 2005). This is well above the Asian average which is about 30 percent. The contribution of informal sector to employment is also large. About 49 percent of the total labour force was outside the formal sector in 1998 (Sandaratne 2004). This estimate is not likely to have captured fully the extensiveness of informal enterprise in the country indicating that the majority of the workforce in Sri Lanka is still in the informal sector. Furthermore, a majority of informal workers in Sri Lanka is women (Jayaweera et al 2000).

The size of the informal foreign trade sector in Sri Lanka is still not completely known. Series of studies by a number of scholars have attempted to identify the size of foreign informal trade in the South Asian region. Taneja et al (2002) have found that Sri Lanka's informal trade with India in the Indian territory is considerably large. The informal trade as a percentage of formal trade in the Indian territory is about 30 percent in 2000-01. The same is about 31 percent in the Sri Lanka

territory. This data is indicative of the fact that the size of informal foreign trade is considerably large indicating that a systematic effort is necessary to address this issue.

The extent of domestic informal trade sector is not known in Sri Lanka. However, obtaining a proper estimate of the total manifold activities in informal domestic trade sector requires a countrywide survey. This paper attempts to use the existing secondary data to determine the extent of informal domestic trade in Sri Lanka providing some guestimates of the domestic informal trade based on some of the derivations from the available official statistics in Sri Lanka.

- First, the self employed workforce is about 59 percent of total workforce in Sri Lanka. A considerable share of this informal workforce would be in the informal trade sector (Department of Census and Statistics 2004/05) since most of the self-employed people are engaged in various types of trading activities.
- Second, though most of the micro and small scale trading enterprises belong to the formal category, the labour force in these trade stalls operating throughout the country provides informal wage labour. These workers hardly get any formal employment contracts.
- Third, the *Sathipola* (Weekly Trade Fair) is operating throughout the country regularly which is one of the model trading systems directly linked with the lower income people in the country. Though large-scale businessmen seem to control much of the activities of the sector, the workforce in *Sathipola* seems to belong to informal category. Most of the customers in *Sathipola* are from the lower income households. In some areas, permanent buildings are available for weekly fairs which were built and maintained by the Local Government bodies, but in most cases traders themselves erect their temporary huts. It is

also evident that trade takes place in these *Sathipola* in highly unhygienic environments. These *Sathipola* lack even very basic facilities required to undertake trading of food products such as vegetable and fruits. There is no proper information available to trading parties linking producers with traders, and then with the customers. In some cases, the small scale traders have been under pressure and been subject to unfair exploitation by large scale formal businessmen who seem to be suppliers of goods traded by informal sellers.

- Finally, there are also a considerable number of itinerant traders throughout the country, especially in urban areas. There seems to be a large number of informal itinerant fish sellers operating throughout the country as distributors of fresh fish and meat. These sellers basically belong to the lower income segments of the society. They are not well-equipped to transport fish due to lack of facilities.

It is evident from the above descriptions that the size of informal trade sector is large in Sri Lanka. Moreover, informal trading activities are basically based in urban areas even though a considerable amount of activities is taking place in rural and estate areas. However, in order to obtain a comprehensive understanding of the extent, anatomy and the characteristics of the informal trade sector in Sri Lanka, a country-wide survey is essential.

Types of goods traded through informal activities vary from agricultural products to manufacturing products which are mostly final products, or consumption goods. These small entrepreneurs trade a wide variety of goods. Kind of goods traded depends on demand, and

traders appear to be sensitive to changing trends and opportunities. Goods normally traded include:

- New clothes and shoes
- Second-hand clothes
- Electronics (TV's, Hi-fi's, CD players; clocks, watches, videos; radios etc.)
- Household goods (pots, plates, cutlery, etc.)
- Bedding (blankets, sheets, etc.)
- Furniture (particularly mattresses, tables and chairs)
- Cosmetics
- Used vehicles
- Vehicle spare parts
- Construction materials
- Processed foods
- Meat, chicken, eggs and milk
- Vegetables and fruit.
- Fish
- Nuts
- Spices,
- Rice and flours

Goods traded in informal sector in Sri Lanka are basically local products other than some manufacturing products imported. Most of these manufacturing products traded in this sector are factory rejects produced for exporting targeting high-end consumers in abroad from domestic

economy and some lower end imports from some foreign companies. However, a large percentage of total goods traded through these informal activities are local products.

#### **4. Reasons for Informal Trade**

In analyzing the contribution of the informal sector, emphasis is placed on the importance of links between formal and informal activities that are not confined to particular occupations or even to economic activities. Informal trade is ‘the way of doing things’ characterized by many factors. In most cases, micro and small scale operators find it convenient to organize themselves in the informal sector than formal sector due to many reasons. Most of these factors are common for both foreign and domestic informal trade. However, our focus is mainly on domestic informal trade. We attempt to briefly document them below.

**Transaction costs:** Apart from production costs, it appears that the transaction costs are lower in informal trade sector than in the formal trade sector. There are a number of sources of transaction costs:

- obtaining a business license
- acquiring land titles or leases
- hiring employees
- knowing and complying with applicable government laws and regulations
- obtaining a loan
- buying supplies
- hooking up and maintaining electricity and telephone services
- paying taxes
- enforcing contracts

- Acquiring accurate information: information is one of the key requirements for efficient functioning of trading activities. Obtaining information about price, quality, and quantity of particular goods and services, about sources of goods and services, and about potential customers usually incur costs. Information is basically valued in four aspects such as quality, quantity, relevance and time lines. Accurate information helps reduce transaction costs of doing business substantially. However, informal traders do not seem to use formal information channels, because costs are higher. They rely on a set of informal means in which social relationships seem to be playing a critical role. Informal traders in Sri Lanka are seemingly using family ties, ethnic ties, and other informal contacts as channels for circulating information.

Percentage of transaction costs out of total costs is very large in micro and small scale businesses if they prefer to operate formally, since production costs are lower. Small scale traders who may find it difficult to cope with higher transaction costs applicable to formal trade are seemingly engaged in informal trade. Since most workers in the informal sector belong to lower income groups, they may find it costly to formalize their micro and small enterprises.

**Presence of high tariffs and non-tariff barriers in official channels:** Though Sri Lanka boasts of one of the most liberal trade regimes in South Asia, there are still various impediments to foreign trade. Sri Lanka's economy is far less liberalized than the economies of the Newly Industrializing Countries in East Asia (Dayaratna Banda 2004). Sri Lanka's main trade policy instrument is the import tariff. A few years ago, Sri Lanka set out to have a simplified transparent two-band tariff system. Nonetheless, the country has deviated from this policy

recently and the tariff structure is now subject to an increasing number of changes. There is irregular and provisional use of exemptions and waivers. There are other charges on imports, including:

- a 10 percent import duty surcharge;
- a 1 percent ports and airports development levy (PAL) on imports;
- a Value Added Tax (VAT) of 15 percent;
- an excise fee on some products such as aerated water, liquor, wines, beer, motor vehicles and cigarettes;
- an Export Development Board fee on all imports where the customs duty is more than 45 percent;
- Port handling charges, and
- A 50 percent margin deposit on the invoiced value of the imports of 44 non-essential items like electrical goods, chocolates, palm oil and cosmetics should be placed by the importers at the time the bank releases the documents (as of 2006).

These trade barriers seem to enhance informal imports through various channels. Strangely, Sri Lanka has a considerably higher rate of export tariffs compared to many Newly Industrializing Countries (Dayaratna Banda 2004), though Sri Lanka boasts of having an export-oriented trade regime for the past three-decades.

**Import Licensing:** In Sri Lanka, a total of 353 items at the 6-digit level of the Harmonized Tariff Schedule code remain under license control, mostly for health and national security reasons. There is a 0.1 percent fee on import licenses.

**Customs Barriers:** Customs process in Sri Lanka involves both procedural delays and paperwork. Sri Lanka customs complains of “fly by night” companies undervaluing goods

brought in from Dubai and China. Customs has also been in the process of installing an Electronic Data Interchange system to support an automated cargo clearing facility. At present, the process is very slow due to procedural delays.

**Presence of high domestic taxes:** high domestic taxes on goods may motivate traders to involve in informal foreign trade. When taxes are high domestically businessmen may attempt to use informal methods to trade goods to avoid taxes. For instance, it appears that a large amount of trade takes place through travelers internationally even within the existing legal framework. Sri Lanka seems to have very complicated tax system. Taxes are also relatively high in Sri Lanka. For instance, Singapore's Goods and Services Tax is 3 percent while the Value Added Tax in Sri Lanka is 15 percent at present.

**Government procurement:** Government procurement is directly associated with basic operations of business transactions in the country. Sri Lanka is not a member of the WTO Government Procurement Agreement. Government procurement of goods and services is mostly done through a public tender process. Some tenders are open only to registered providers. Government publicly subscribes to principles of international competitive bidding, but charges of corruption, malpractices, and unfair awards to political followers of the governing party continue. The process is highly politicized. All tenders presented for Cabinet approval now need to be routed through a cabinet subcommittee chaired by the Minister of Finance. Since the President being the Minister of Finance who enjoys immunity for all his acts, the government procurement decisions may not be challenged in courts. This subcommittee does not encompass qualified tender evaluation experts at the decision making level. There are no professional tender evaluation experts in Sri Lanka. Tender board members are routinely pulled from other jobs based on the political affiliations by applying limited evaluative capacity and lengthening the

tender process. Apart from these possibilities for national level mal-procurement of government projects, the decisions at the provincial and local government level state institutions matter very much for the poor. All the tender processes at the provincial and local government levels are also handled by elected politicians of the governing party along with loyal bureaucrats. Decisions are generally guided by the whims and fancies of this group who seem to exhibit a “herd behavior” in making basic decisions. This compels micro and small scale businesses to go informal. These decisions are not transparent. Poor people are excluded from the basic decision making process.

**Less prone to corruption and red tape:** Corruption is widespread and persistent in the public sector in Sri Lanka. The corruption perception indexes created and maintained by the International Country Risk Services and Transparency International indicate that corruption is an endemic phenomenon in Sri Lanka, especially in the lower ranks of the government bureaucracy (See Dayaratna Banda 2004). Due to presence of corruption and institutional weaknesses traders may tend to evade laws and operate informally. One of the important observations is that corruption at the lower ranks of the government bureaucracy affects poor people very badly. Therefore, elimination of corruption at the top-level of government, though very essential, does not suffice to eradicate poverty much if lower level petty corruption and bribery is not eliminated.

**Faster realization of payments than formal channels:** This is an important aspect since small scale informal traders are operating with a very small amount of capital which compels them to engage in highly liquid transactions. Maintaining high liquidity assets related to transactions are very essential for running businesses in the informal trade sector.

Apart from the above factors, a number of other factors specifically affecting domestic informal trade are:

**Size:** the size of a unit of informal activity seems to be very small when measured on the basis of both number of employees and the amount of capital. These traders rarely use expensive capital equipments in their operations. The activities are basically labour intensive.

**Competitive markets:** Informal sector trade seems to take place in competitive environments compared to formal sector trade. Market forces determine basic parameters of markets. Even though a certain degree of monopoly behavior can be observed, this sector is completely out of various government interventions.

**Easiness of entry:** Existing legal framework which affects the business sector appears to be an impediment for healthy functioning of very small and micro enterprises. In order to start up a new business and running a business, entrepreneurs need to undergo a very hectic process. This involves various things:

- Legal requirements:
  - Existing laws:
    - Goods and Services (Control and maintenance) (Temporary provisions) Act No 14 of 2003.
    - Consumer Affairs Authority Act, No 9 of 2003.
    - Business Name Ordinance, 1918.
    - Fraud Prevention Act, 1840.
    - Business Partnership Ordinance of 1890.
    - Industrial Ordinance, no 45 of 1942.

- Company Act No 51 of 1951 which was drafted based on the Company Act of 1929 in UK. Amendments were done in 1938, 1964, and 1967.
- Currently applicable company law is the Company Act No 17 of 1982.
- Types of organizations allowed: Single proprietorships, Partnerships, Companies, Non-Profit Organizations.
- Basic things to be completed to start up a business are:
  - Registration of the business
  - Registration of the proposed name of business
  - Requirements that must be fulfilled under the environmental laws
  - Business amendments.
- Single Proprietorship:
  - Registration of company name: whether the business is going to be setup in an old or new premise is relevant. Divisional Secretariat must issue a clearance in this regard. If it is in an old premise, DS must declare that the old business is legally shut down. If old business has not been shut down legally, the new businessman must produce documentation to legally shut down the business. Thereafter, the DS issues a clearance certificate.

- Once the clearance is obtained, a duly filled application form along with the clearance letter must be submitted for approval by the Company Registrar. Legal property titles must also be produced.
- Apart from the above, for trading businesses, commercial permit should be obtained from the relevant local government body. In most cases political favoritism places a lead role since the important decisions at these local government bodies are taken by the politicians in power. Political opponents are ill-treated in these processes.
- Partnerships:
  - In order to start up a partnership, a minimum of 2 and a maximum of 20 individuals are necessary.
  - Application for a partnership involves a complex process. The requirements are: name of partnership, nature of partnership, names, addresses, and designations of partners, and the address of the main office.
  - According to Partnership Ordinance of 1890, a partnership can be started up by: written agreement, verbal agreement, and implied agreement.
  - Each partner of the partnership functions as an agent of the other partners.

- An agreement signed by all the partners before a Justice of Peace should accompany the application.
- A letter signed by all the members should be attached.
- The registration is done by the Company Registrar after going through lengthy deliberations.
- This process is also both costly and time consuming.
- Companies:
  - Currently, companies can be formed according to Company Act of 1982.
  - Other relevant laws are: Goods and Services (Control and maintenance) (Temporary provisions) Act No 14 of 2003; Consumer Affairs Authority Act, No 9 of 2003; and Industrial Ordinance, no 45 of 1942
- This information makes it clear that formal operation is highly costly due to the existing entry barriers in the formal sector for small and micro scale trading enterprises.

**Paperwork:** the above mentioned legal requirements in the formal sector involve lot of paperwork. Micro and small scale traders seem to evade these requirements by operating informally. In order to make timely exploitation of business opportunities, small and micro scale traders may be compelled not to use formal channels for doing business due to heavy paperwork.

**Procedural delays:** formal traders have to undergo various procedures when undertaking a business transaction as a result of complying with the existing laws. Small and micro enterprises seem to evade these procedural delays by operating informally.

## 5. Some Implications

Even if informal trade is a natural phenomenon, informal businesses themselves face with various problems as a result of operating informally. This provides the basis for taking measures to develop the sector by linking with the formal sector. The paper draws attention to the following aspects in this regard.

**Quality of products and services:** quality of the products traded in informal market is very low. There are no quality guarantees. Customers are not able to secure quality of products since sellers are not operating under regulated requirements. Because of these reasons traders find it easier to cheat the customers. However, this is not basically a long term aspect of informal business, since informal businesses are conscious about the customer confidence. *Sathipola* in Sri Lanka are operating in a very unhygienic market environment. It is disheartening to note the horrible state of the *Sathipola* in Sri Lanka.

**Access to financial resources:** Informal businesses are deprived of access to resources due to various reasons. Informal traders need to rely on informal financial sources for financing their business since they do not have access to formal channels. Though transaction costs in informal financial sector is low compared to formal sector, interest rates and collateral requirements are very high in informal financial sector. Informal trade sector does not have access to formal financial resources because formal financial sources require legal property titles, legal business transactions, as well as established business practices, together with standard accounting practices. Lack of access to formal financial resources seriously impede the growth of this sector and create sustainability issues. One of the main arguments in favor of formalizing informal trade is that formal operations increase the access to resources.

**Dispute settlement mechanisms:** businesses naturally involve various disputes. Illegality of informal entrepreneurs precludes them from using existing legal system to enforce contracts. The result is that they minimize risks by only engaging in short-term contracts with known partners involving small amounts of money. This limits their ability to expand and to benefit from economies of scale. In some cases, informal enterprises, deprived of access to the legal system, seem to resort to violence to enforce agreements or property rights. More powerful informal traders deliberately use force to deter new entrants into informal trade sector, as well as to limit the activities of poor segments of the sector. There are also cases where new entrants into informal trade sector as well as poor incumbents have to pay ransoms and other charges for people who seem to illegally regulate the activities of the sector. It is not rules and regulations that govern the activities of informal trade sector, but whims and fancies of a privileged few operating in the sector as larger businessmen or as thugs (law enforcement mechanism in the shadow economy) who seem to have a monopoly in decision making in the sector. Entrepreneurs belonging to lower income segments of the society do not get an opportunity to run informal businesses in a productive, efficient, and profitable manner as a result of this.

**Information availability:** Information plays an important role in business transactions. Provision of accurate information requires a certain degree of government's involvement. Since informal enterprises are positioned outside of the government purview of operation due to lack of legality, government may not attempt to develop information systems for the benefit of informal sector. Lack of accurate information hinders progress of informal trade sector in Sri Lanka.

**Social security schemes:** A well-developed social security mechanism for informal sector is lacking. Employees in informal trading sector face with serious problems at the old age. Various existing social protection facilities, health insurance schemes, micro finance schemes, old age

protection (ETF, EPF) are not conveniently accessible for informal sector workers. Moreover, they lack facilities for risk minimizing. Formal sector employees have access to various social security schemes such as EPF, ETF, and gratuity, while pension funds are available for farmers and fishermen, though these social protection programs are not well functioning due to improper planning, resource constraints, and politicization. Lack of social security scheme seems to be a serious problem faced by employees in informal trade sector.

**Misguided policies:** Because members of informal sector operate clandestinely, they have little opportunity to voice their concerns to government officials and thus policies are less responsive to their needs. The traders are normally at the mercy of politicians and some bureaucrats to remain in business. Their lack of property rights fosters a concentration of economic power in the hands of a small number of elites who control government policymaking and large portions of economic activity through monopolies. Many macroeconomic policies in Sri Lanka target whole economy based on informal on formal sector, disregarding nearly a half of economic activities of the country. Because informal sector activity is not fully included in official statistics, government policies and regulatory institutions that affect the entire population are made without data on a substantial amount of economic activity. This leads to misguided policy responses.

**Competitiveness:** Absence of well-designed, cost-efficient, stable institutions protecting property rights and contracts prompts businesses to minimize costs and risks by integrating vertically through informal methods. This reduces firms' flexibility and mutes market signals. Moreover, lack of a proper incentive structure hinders enterprises from decentralizing, specializing, subcontracting with competitive suppliers, offering reasonable insurance premiums.

This hinders progress of informal enterprises. Moreover, erosion of competitiveness results in deteriorating overall economic performance engineered by informal sector's performance.

**Lack of access to essential public goods and services:** Utility connections (water, electricity and telephone) require a legally recognized property title or lease as a form of securitization. Because most informal traders do not have property titles, they may be deprived of water, electricity and phone service. In some cases, informal traders have little choice but to tap electrical, water and telephone lines illegally, thereby raising the cost for regular subscribers.

**Lack of security for properties:** since informal sector businesses lack legally accepted property titles, insurance is a major issue. The informal sector trading units are highly endangered economic activities. There needs to develop appropriate mechanisms to protect the informal sector properties.

**Implication of Formality/Informality on Poverty:** On one hand, informal economic activities increase and reinforce poverty and inequality. Those who work in informal sector tend to earn low incomes because of ill-designed institutions, particularly property rights regimes, discourage or prevent them from using their assets productively or from obtaining reasonably priced credit to expand their businesses. Workers are paid lower than desirable wages due to lack of legal protection. These informal workers do not have access to existing social security schemes. Thus, they remain impoverished. However, formalization of informal trade in the conventional manner also has serious implications on poverty. If formalization means forcing these traders to abide by various rules and regulations, forcing them to obtain formal property titles, business permits, and asking to follow procedures etc, cost of doing business will increase remarkably making it impossible for micro and small scale entrepreneurs who come from lower income groups to engage in any productive economic activity. This seems to kill small potentials of this sector.

This practice of formalizing a business and continuing it as formal entity is highly costly for the poor people who seem to be engaged in informal economic activities. Therefore, formalization of these informal trading enterprises, in the way what we know of formalization today, has negative impact on the poor. However, formalization of relationships may not have this possibility. This compels one to investigate possible new forms of affiliations with formal firms in order to increase opportunities for micro and small enterprises.

## **6. Some Recommendations for Restructuring Informal Trade Sector**

This section attempts to identify a set of guidelines in a market-based approach that can help to reform informal trading sector in Sri Lanka. The premise of this paper is that markets are most often the best way to organize economic activity. Though market itself is considered to be an institution, there needs to be supporting institutions for markets to function effectively. Therefore, there is an increasing role for government in the form of creating the required incentive structure for markets to work effectively. This seems to be crucial in developing informal sector. In here, we examine the possibility of linking formal and informal sectors in most cases, and developing informal trade where such efforts are socially welfare enhancing. It is not possible to assert linking informal and formal trade when it comes to foreign informal trade. In case of foreign informal trade, things need to be done in order to reduce or eliminate them. Following specific things are recommended to be included in a comprehensive framework to develop informal sector in Sri Lanka:

**Adjustment Mechanism:** It is necessary to create necessary conditions for voluntary formalizing if socially desirable. Informal traders should be allowed to decide whether they are

willing to enter the formal mechanism. There are adjustment costs for restructuring. Entrepreneurs in informal sector may find it difficult to bear adjustment costs which may in some way compel them to be out of formal sector, even if restructuring programmes are implemented without an incentive package which includes a considerable degree of financial support to assist new micro and small scale formals to sustain business until they become affordable to pay various charges to government. There should be some kind of adjustment funds to support these entrepreneurs during adjustment period. A proper transition mechanism is necessary. This requires a particular form of government intervention.

**Employment contracts:** Under existing arrangements between entrepreneurs and workers in informal trading sector, employees seem to be not getting due shares for their efforts. Entrepreneurs possess some form of upper hand which helps them to get unfair advantages. Therefore, measures are needed to formalize employment relationships between formal firms and informal wage workers. This will help reduce poverty since most of the workers in this sector seem to come from the poorest segment of the society who seems to earn around a dollar per day.

**Commercial relationships:** There are linkages between formal firms and informal enterprises. In most cases, formal firms supply merchandise to informal enterprises. Powerless informal enterprises are subjected to unfair exploitation by formal firms which are normally stronger than informal enterprises. Measures need to be taken to formalize business relationships between formal firms and informal enterprises.

**Property Rights:** Lack of property titles limits the access to public goods and services for informal enterprises. In order to increase accessibility of public goods and services to informal traders, proper property titles for these enterprises are needed. However, there should be specific

measures to prevent imposing additional costs on these micro and small enterprises in the form of taxes, business permit charges etc. The informal enterprises can be offered tax exemptions and other similar incentives for a short to medium term when they obtain property titles, when they are decided to operate as formal entities.

**Social security:** Design and implement effective social security schemes for informal traders, at least similar to those implemented for the farmers and fishermen.

**Marketing conditions:** Surveys need to be done in order to identify as to whether there are naturally emerged sales points attached to micro and small enterprises. These sales points need support for development. For instance, *Laksala* was built as sales points for small and medium industries. The naturally emerged sales points, such as *Sathipola*, should be developed to support the manufacturing sector as a network of sales points.

**Facilities:** Provide basic facilities to continue informal trading activities:

- *Sathipola* (weekly trade fair): both living conditions of workers in this sector and quality of services can remarkably be improved by providing basic facilities to these sales centers. This can be used as a role model for developing trading activities since majority of lower income groups are using this facility constantly.
- Itinerant fish traders: these traders are mostly from the poorest segments of the society. Sellers use either push bicycles or motor-bicycles or hired or mortgaged three-wheelers for running their livelihoods. It may be possible to design a programme to assist these sellers to buy and maintain these equipments at bearable costs. Since fish is supplied by formal traders, this relationship needs to be developed to help improve transacting conditions for the benefit of these

itinerant traders. Consumers will also benefit from this by being able to buy high quality products at lowered prices from these itinerant sellers.

**Eradicate Entry Barriers:** Take measures to eradicate entry barriers available in formal sector.

- When restructuring, there should be measures not to impose additional costs on micro and small scale trading sector as transaction costs,
- Possibility of providing business licenses and property titles for micro and small business free of charge or at very small costs should be searched.
- Implement tax exemptions and other incentives as part of reform package,
- Reduce complexity of rule and regulations,
- Guarantee stability/predictability of laws and regulations
- Improve existing dispute settlement mechanism, or develop a dispute settlement mechanism for small and micro enterprises,
- Measures should be taken to ensure that formal regulatory environment is not biased in favor of formal firms and workers over informal enterprises and workers (or vice versa),
- Eliminate procedural delays by improving quality of bureaucracy, eliminating corruption especially at lower ranks of bureaucracy, and strengthening meritocratic recruitment of government workers,
- Reform and strengthen property rights systems applicable to small and micro scale businesses.

**Pro-Poor Business Rules and Regulations:** Pro-poor business rules and regulations need to be developed by streamlining business permit requirements and procedures. In most cases poor

people have little access to legal system as a result of high cost involved. Procedural delays and paper work tend to affect badly for the poor to run small and micro businesses.

**Training:** Government involvement is required to provide training facilities to informal traders. Public goods nature of knowledge is the basis for this kind of government intervention.

**Trade Liberalization:** In order to reduce informal foreign trade, trade liberalization should gradually and systematically be done. This may involve unilateral liberalization, regional trade agreements, bilateral agreements, and intra-regional agreements. But, sine there are limits to the degree to which an economy can be liberalized due to many natural barriers, another possible approach will be to develop a special form of license scheme to allow these informal traders to continue business while complying with laws and regulations, especially designed to cater to needs of these informal traders considering overall welfare implications of such an exercise.

## **7. Concluding Remarks**

Nature, extent, anatomy, and characteristics of informal trade sector in Sri Lanka are not completely known at present. As a result, informal trade sector in Sri Lanka has got a scant attention from policy makers. It appears that most poor people sustain their livelihoods by either being self-employed or by providing labor to these informal trading enterprises. Moreover, a majority of informal sector workers is women. There seems to be no established commercial or employment contracts in this sector, safeguarding the rights of workers. Poor and powerless workers in this sector are subject to unfair exploitation due to lack of employment protection.

We concludes that letting the informal trading sector to operate as of now is not effective in eradicating poverty. New ways and means, as suggested in the paper, should be searched and

implemented to restructure activities of informal trade sector without imposing additional burden by way of costs on people who are involved in the sector. These reform efforts should be done under market-oriented economic system by making serious and effective measures to improve the “incentive structure” of the economy to facilitate efficient functioning of private enterprise from micro level to large scale. “Incentive structure” of the country needs to be developed in order to provide just and equitable business conditions for all scales of business operations.

Our analysis in this paper is based on the available secondary data and the information drawn from the literature, as well as some field observations. But, our understanding in this sector is very limited. Currently available information is not sufficient to arrive at decisive policies. A countrywide survey needs to be undertaken to ascertain the size and characteristics of informal trade. This data base can then be continuously updated.

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